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SUBJECT: BOMBARDIER AND THE WORLD AIRCRAFT SUBSIDIES GAME

REF: OTTAWA 822

SUMMARY/INTRODUCTION

1. This report outlines a significant part of the backdrop to the WTO's current aircraft subsidies case: Canadian-based Bombardier Aerospace and the market for 100-seat-and-up "regional jets" - airliners at the small end of the product ranges offered by Boeing and Airbus.

2. Bombardier announced in May 2005 that final assembly of its proposed "C series" aircraft would occur in the Montreal area, after it played the Canadian federal and Quebec provincial governments off against other jurisdictions for subsidy commitments. This represents a solid renewal of Canadian governments' commitment to subsidies in manufacturing industry (reftel). If the C series goes ahead, it also represents a step by Bombardier into the 100-seat-and-up product range, which is dominated by Boeing and Airbus and their major (as opposed to regional) airline customers.

3. Bombardier's political connections in Canada are legendary. In a bitter dispute (1996-2001) with Brazil's Embraer, the GOC proved willing to play hardball to support the company in trade litigation and in the market. Bombardier and its suppliers account for some 30,000 jobs, many of them in politically crucial constituencies around Montreal. Moreover, Canada can afford (probably better than Brazil) to continue this support. END SUMMARY/INTRODUCTION.

THE COMPANY

4. Canada's aerospace industry, with more than 400 firms employing over 80,000 people (see industry website www.aiac.ca), claims to be the largest in the world after those of the United States and the combined European Union. As in other Canadian manufacturing industries, integration with the U.S. market (including access to defense contracts) has facilitated growth particularly among parts manufacturers and service providers since the 1940's. Canada's own very small military budget has been a disadvantage for this sector, providing few opportunities to produce entire aircraft, and (as in shipbuilding) this has been used to help make the case for direct government support.

5. Bombardier - which pioneered the snowmobile in the early twentieth century and later expanded to motorcycles, boats and rail/subway systems - grew into aerospace in the 1990's through acquisition of Canadair (Quebec), de Havilland (Ontario), Shorts (U.K.) and Learjet (U.S.). Combining existing strengths in turboprops and business jets, Bombardier caught a strong trend in the 1990's toward the use of 50-to-70-seat regional jets on inter-city routes in North America.

6. Bombardier's current commercial offerings (based on designs more than a decade old) are turboprops carrying from 37 to 56 passengers and jets ranging up to 90 seats (see website www.bombardier.com). In the late 1990's, Bombardier considered developing a 115-seat model, but held back - a decision that may have been fortunate given the post-2001 sales slump. With airline profits reviving, Bombardier is discussing the 110-to-130-seat "C Series" with prospective customers and has selected Montreal as the assembly site but has not made a final launch decision.

SUBSIDY PROGRAMS

7. Taxpayer funding to Bombardier is channeled through

the following major routes:

TECHNOLOGY PARTNERSHIPS CANADA (TPC): This is a GOC program of loans to finance research and development (see website www.tpc-ptc.ic.gc.ca). While the loans are nominally repayable, less than five percent of the value of all TPC loans has been repaid so far (data for individual firms are not released). And while TPC loans are nominally available to industries other than aerospace, the bulk of funding is awarded to Bombardier and a few other aerospace players, including Canadian branches of some U.S.-based firms. GOC officials argue that the time frames for repayment are necessarily long, and in recent weeks Industry Minister David Emerson commented that expecting full repayment would not be realistic. Critics of Bombardier's influence in the GOC say that TPC's repayment conditions are deliberately pitched so high that they will never be triggered. The Canadian Taxpayers Federation (see website www.taxpayer.com) estimates that including its commitment to the C Series, the GOC's cumulative direct contributions to Bombardier total C\$1.12 billion (about US\$900 million). As a result of adverse panel findings in the dispute with Embraer (see below), TPC has been crafted to withstand WTO challenge.

EXPORT DEVELOPMENT CANADA (EDC): This is the GOC's official export credit agency (counterpart to Eximbank). While details of loans made on EDC's own account are not publicly available, EDC claims compliance with the OECD's "consensus arrangement" for official export finance. In addition to lending its own funds, EDC sometimes supports Bombardier sales (and those of a very few other exporters) with funds drawn directly from the GOC treasury (the "Canada account"), with case-by-case approval from the GOC. This mechanism has even been used to support Bombardier sales to Air Canada. See website www.edc.ca. At the end of 2004, EDC had C\$6.8 billion in exposure to aerospace customers (about one-third of EDC's total exposure) and C\$7.3 billion in exposure to surface transportation customers, another major business segment for Bombardier.

DIRECT RESEARCH: Over the past year the GOC has constructed and staffed an Aerospace Manufacturing Technology Centre, located in Bombardier's hometown of Montreal, whose mission is to help this industry reduce manufacturing costs. See website www.iar-ira.nrc-cnrc.gc.ca.

SUB-FEDERAL SUPPORT: Like the GOC, the provincial Government of Quebec supports Bombardier with "repayable" loans (including C\$118 million for the C Series), equity guarantees to aircraft buyers, and other measures such as infrastructure investment, worker training and tax holidays.

THE BATTLE WITH BRAZIL

18. Bombardier's most direct competitor is Brazil's Embraer, a larger firm with a wider range of planes offered (a 118-seat commercial jet is expected to be certified for service in 2006) and a stronger defense products business. Unlike Bombardier, Embraer started as a state-owned firm, but during the 1990's it was privatized and, like Bombardier, prospered by catching the trend toward "regional jets." The main subsidy mechanism for Embraer is an export financing program called Proex, which purports to compensate for Brazil's high interest rates.

19. Bombardier first enlisted the GOC to complain to Brazil about Proex in the mid-1990's, eventually impeding (some say killing) Canada's plans to conclude an FTA with the Mercosur trade bloc. Special envoys appointed to resolve the dispute proposed a bilateral pact based on OECD subsidy rules, but (by Canadian accounts) Brazil refused this solution. The countries traded WTO complaints in 1998, and the resulting panel found Proex and TPC, as well as the use of the Canada Account mechanism for aircraft sales, all to be illegal.

110. Both countries adjusted their programs but Brazil's revised "Proex 2" was also successfully challenged by Canada at the WTO. Meanwhile, however, Embraer continued to win sales orders for regional aircraft. In 2001, faced with a situation where it felt that it was winning at the WTO but losing in the marketplace, Canada decided to match the Proex advantage by offering Bombardier's customers expanded below-market financing through EDC and the "Canada Account." As a result, Bombardier won two critical orders from U.S. airlines (for a total of 225 planes).

¶11. While Bombardier regained its competitive position, trade policy watchers believed that Canada lost moral credibility at the WTO by resorting to unauthorized retaliation. Moreover, the escalation in the diplomatic dispute with Brazil (which also involved a spat over beef trade) scuttled any prospect of Canada-Brazil collaboration at the time on wider trade policy goals such as hemispheric free trade.

¶12. The dispute wound down in 2002-03 with a negotiated peace. Bombardier and Embraer split major orders from US Airways and Air Canada. In the Air Canada deal in September 2003, while the two suppliers divided the units evenly between them, Embraer obtained all the orders for larger planes - underscoring the need for Bombardier to bring forward a new design in the 100-seat-plus market.

COMMENT - KEY QUESTIONS

¶13. In our view, two key sets of questions hang over the market for aircraft seating 100 to 150 passengers:

-- How will Boeing and Airbus respond to encroachment from Bombardier and Embraer? Boeing is discontinuing its 106-passenger 717 model, but still offers versions of the 737 with from 110 to 189 seats. The Airbus A320 "family" covers a similar range.

-- Even if Boeing and Airbus were to effectively cede the smaller end of this market, how would Bombardier and Embraer manage the resulting duopoly? Will they continue to induce customers to split major orders between them? And if so, might their sponsor governments have an incentive to reduce subsidy levels in this industry?

¶14. We see little prospect that subsidy levels to Bombardier in Canada will decline. The firm and its suppliers are the flagship industry in Quebec constituencies which are intensely contested by federalist and separatist parties at both the federal and provincial levels. Bombardier watchers say the firm's political connections will survive any foreseeable change in government and will keep the dollars flowing.

WILKINS